Example examination questions

Chapter 3: The New Zealand Framework

Q1 Distinguish between 'general purpose' and 'special purpose' financial statements and outline the significance of this distinction.

A1 General purpose financial statements are those specified in the NZ Framework. They are termed 'general' because they are prepared to meet the information needs of a wide range of users. Special purpose financial statements are external financial statements intended for specific users who are able to determine the information to be reported to them. Examples include the IRD for tax purposes, and lenders such as banks or other financial institutions.

The significance of the distinction is that accounting standards are compulsory only in respect of general purpose financial statements. Essentially, accounting standards provide a safeguard for the information needs of users who, in their own right, are unable to obtain the necessary information.

Q2 The NZ Framework serves four main functions in supporting the presentation of a true and fair view in financial reporting – interpretation, benchmarking, audit and philosophical. Discuss how the NZ Framework works in each of these functions.

*A2 **Interpretation** – the NZ Framework sets out principles that underlie financial statements, so that they comply with Generally Accepted Accounting Practice (GAAP); external users can thus rely on the consistent treatment of similar accounting transactions between entities, and from year to year.*

***Benchmarking** – the NZ Framework provides a benchmark of rules and principles to be followed by accountants in preparing financial statements.*

***Audit** – the NZ Framework provides rules and principles to be followed that assist auditors in forming an opinion on whether financial statements present a true and fair view of an entity's results and position.*

***Philosophical** – the NZ Framework provides principles and consistent methods of reasoning on which accounting standards are based.*

Q3 It is vital that financial statements can be relied on. What steps would you recommend an organisation takes to ensure that the information in its financial statements achieves this?

A3 Accounting information must faithfully represent all material events and transactions during the reporting period based on economic reality and not merely their legal form. It *must be free from any bias (be neutral), be complete and as appropriate be conservative in nature (prudent) rather than optimistic.*

Possible steps could include:

- *More detailed disclosures in financial statements than what is required by accounting standards.*
- *Identifying in the financial statements the more subjective aspects of the reported information.*
- *If not already required, having the financial statements audited.*

Q4 Explain the term ‘period reporting’. Why is this concept important?

A4 The period reporting concept requires preparation of financial statements based on defined time periods, typically one year. Although the periods may vary from business to business, they should be regular periods within the same entity.

This concept is important because it enables users of the financial statements to track and compare financial performance of an organisation on a consistent basis, between different entities and between different years.

Q5 In a company that you work for, a building which cost $150,000 ten years ago now has a market value of $400,000. For financial statement purposes, what arguments would you put forward to convince your Chief Executive Officer that this building should be shown in the financial reports at its current market value?

A5 The historical cost of $150,000 was a fair value of the building 10 years ago. This value does not recognise the current value of the building, which is $400,000. The adoption of the current market value (which must be certified by qualified valuers) ensures that assets in the Balance Sheet are not underestimated and therefore reflects the fair values for those assets.

Q6 According to the NZ Framework, it is appropriate to use multiple measurement bases. What does this mean, and what disclosure must be made?

A6 This means that organisations can use several measurement bases, in conjunction with one main base such as historical cost. Thus historical cost may be the main valuation measurement base, but others such as current values, net realisable value or present value may also be used. For example, inventory can be valued at the lower of cost and net realisable value, and non-current assets can be periodically measured at current fair values.

The use of mixed bases requires full disclosure of individual item measurements.

Q7 Briefly explain the purpose and function of Accounting Standards, distinguishing between an IFRS and an NZ IFRS.

A7 An IFRS is an International Financial Reporting Standard, produced by international accounting bodies.

An NZ IFRS is an International Financial Reporting Standard that has been adapted for New Zealand conditions for use in New Zealand.

The purpose of international accounting standards is to promote conformity and consistency in financial reporting nationally and internationally.

Q8 Briefly contrast cash accounting with accrual accounting, in terms of the types of transactions that are recorded under each system. Which is the most objective system?

A8 Cash accounting only records cash transactions – i.e. a transaction is recognised (recorded) only when cash is either paid or received.

Accrual accounting records cash transactions, but also transactions on credit as well as balance day adjustments.

Cash accounting is the most objective system, as it allows no discretion in the amount or timing of recording transactions; there is no scope for manipulation.

Accrual accounting involves estimates and judgement to be applied to the recording of transactions, and thus it is less objective. It provides an opportunity for managers to manipulate results and positions to make them look good.

Q9 Explain the 'monetary assumption', the 'going concern assumption' and the 'accounting period assumption', giving an example for each assumption in the financial statements.

*A9 The **'monetary assumption'** means the expressing of financial transactions in a common currency.*

An example is the conversion of overseas currency to the New Zealand currency equivalent in financial statements.

*The **'continuity (going concern) assumption'** means that financial reporting of an entity is done on the basis that it will continue operating in future accounting periods.*

An example of the application of the going concern assumption is that non-current assets may be valued at historical cost, rather than current or liquidation values, in the financial statements. As the entity is expected to continue, current or liquidation values may not be relevant to any management decisions.

*The **'Accounting period assumption'** means that the life of an entity is divided into consistent time periods for financial reporting, usually 1 year.*

An example is found in the title of the Balance Sheet – '… as at 31/03/20X1' – which shows the value of assets, liabilities and owners' equity at the end of each year.

Q10 Match the assumption/principle in column 1 with the best illustration of an implication in column 2.

Column 1	Column 2
Going concern	A The accounting system records cash transactions, credit transactions, and balance day adjustments, rather than just cash transactions.
Accrual basis	B To enable valid comparisons to be made year by year, and between different firms, Income Statements are prepared on a regular annual basis.
Period reporting	C An entity is expected to continue operating into the future, therefore non-current assets are valued at historical cost rather than current fair values, as the firm has no intention of selling them.

A10 Going concern – C

Accrual basis – A

Period reporting – B

Q11 There are 3 main points to the NZ Framework definitions of an asset. Apply those 3 main points to each of the following scenarios, and determine whether an asset should be recognised and recorded in the Balance Sheet.

a A firm is involved in a court case in which it is suing a competitor for $100,000 for copying its product and trademark. The court case has not yet been decided.

b A firm has signed a contract of purchase for 2 tonnes of bananas in Ecuador, and also has an insurance contract for loss of sales and profits if the bananas are damaged, lost or held back in any way from the voyage to New Zealand.

c A firm has just signed a world-famous New Zealand netballer to work for them in a marketing position. The netballer's international contacts and high profile are expected to win the firm several lucrative contracts. The contract of employment may be terminated by either party, provided written notice is given 2 weeks in advance of the termination date.

A11 a Control over the asset – the firm does not have control over the outcome of the court case and award of $100,000.

Result of a past event – the court case decision is not yet a past event.

Future economic benefits – there is the possibility of a future economic benefit of $100,000.

No, this should not be recorded as an asset, as it fails the control and past event requirements for an asset.

b Control over the asset – the firm does have control over the bananas or the sales and profits if the bananas are lost.

Result of a past event – the firm has already signed contracts for the bananas, and for the insurance.

Future economic benefits – either the bananas or the insurance contract will provide the firm with future economic benefits.

Yes, this should be recorded as an asset, as it passes the control, past event and future economic benefits requirements for an asset.

c *Control over the asset – the firm does not have control over the employee; she is free to resign with 2 weeks' notice.*

Result of a past event – the signing of the employment contract is a past event.

Future economic benefits – the netballer's international contacts and high profile are expected to win contracts for the firm.

No, this should not be recorded as an asset, as it fails the control requirement for an asset.

Q12 Match the assumption/principle in column 1 with the best illustration of an implication in column 2.

Column 1	**Column 2**
Understandability	A Accountants must know something about the decisions to be made. In order to supply the most appropriate information, the accountant must know something about the decisions for which the information is required.
Relevance	B When two or more different accountants measure the result of a business transaction, both should obtain approximately the same results.
Reliability	C The financial results of other firms within the same industry may be used to assess the firm's position or performance.
Comparability	D If financial reports are prepared for unskilled users, the accountant should ensure that the reports are as simple as possible.

A12 Understandability – D

Relevance – A

Reliability – B

Comparability – C

Q13 How does the Statement of Accounting Policies and its required content fulfil the ‘concept of comparability’?

A13 The disclosure of accounting policies adopted by an entity in preparing its financial reports enables readers of those financial reports to understand the bases for the figures reported in the financial statements, and any changes or variations due to changes or variations in accounting policies.

The required content of the Statement of Accounting Policies thus fulfils the ‘concept of comparability’ by enabling readers to make educated comparisons between entities that may use different accounting policies, and between the reports of the same entity for different periods.

Q14 Match the assumption/principle in column 1 with the best explanation or illustration in column 2.

Column 1	**Column 2**
Materiality Neutrality Prudence Completeness	A If any uncertainly exists in valuation of assets or revenues, an accountant should lean towards conservative rather than optimistic values. B The omission of information that is relevant could result in the financial statements being misleading, so financial statements should include all relevant information. C Financial statement information should be prepared free from any bias that may influence a user i.e. presenting a more successful result for the period than actually occurred. D Large companies in New Zealand may report their results rounded to thousands of dollars, as showing results in single dollars does not add any significant benefit or understanding to readers.

A14 Materiality – D

Neutrality – C

Prudence – A

Completeness – B

